

REPORT OF EXAMINATION
OF THE
SAFEWAY DIRECT INSURANCE COMPANY

AS OF
DECEMBER 31, 2005

Participating State
and Zone:

California

Filed December 6, 2006

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Los Angeles, California
September 22, 2006

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Subcommittee
Commissioner of Insurance
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Gary L. Smith
Secretary, Zone IV-Western
Director of Insurance
Department of Insurance, State of Idaho
Boise, Idaho

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman, Director and Commissioner:

Pursuant to your instructions, an examination was made of the

SAFEWAY DIRECT INSURANCE COMPANY

(hereinafter also referred to as the Company) at its statutory home office located at 222 East Huntington Drive, Suite 200, Monrovia, California 91016.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2002. This examination covers the period from January 1, 2003 through December 31, 2005. The examination was made pursuant to the National Association of Insurance Commissioners' (NAIC) plan of examination. The present examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2005, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: company history; fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

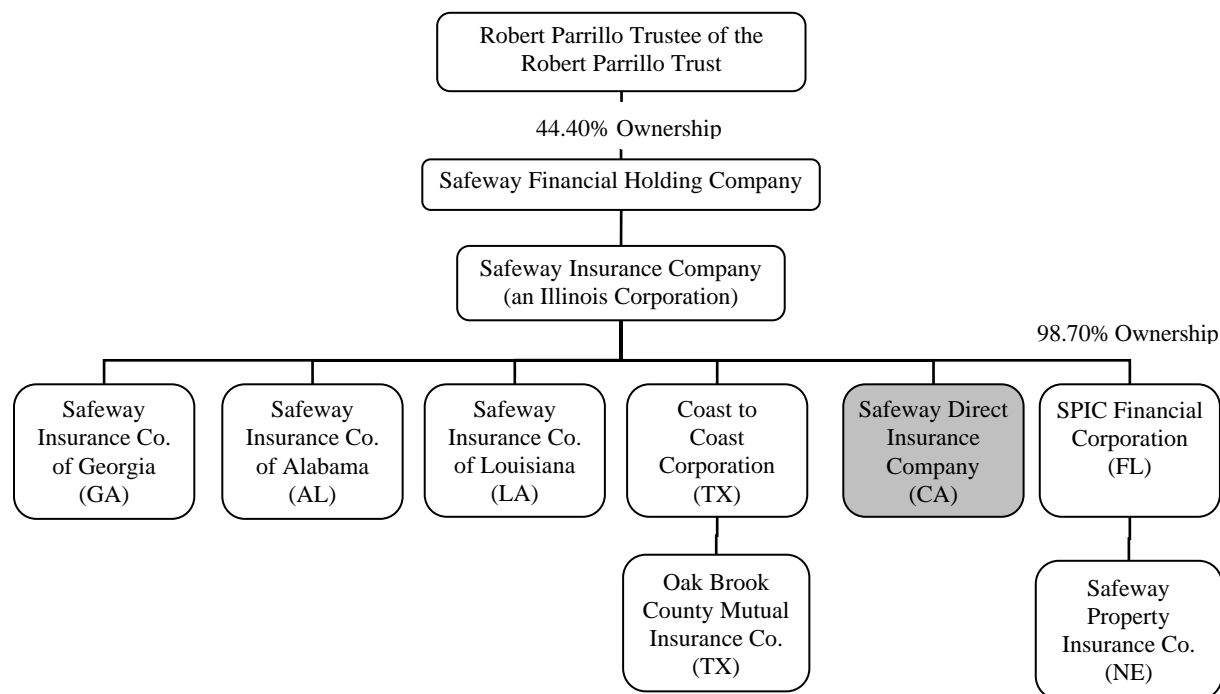
SUBSEQUENT EVENTS

On January 1, 2006, the Company, along with its parent, Safeway Insurance Company (SIC) and some of SIC's insurance subsidiaries, entered into an Inter-Company Pooling Agreement. Under the terms of the Agreement, the Company and its insurance affiliates are required to cede 100% of net premiums, losses and other underwriting expenses to SIC. SIC is required to retrocede net premium, losses and other underwriting expenses to the Company and insurance affiliates at contractually determined pooling percentages. The Company assumed 3% of the pooled premiums, losses and other underwriting expenses effective January 1, 2006. The California Department of Insurance approved the Inter-Company Pooling Agreement on February 8, 2006.

The Company has become a licensed insurer in the State of Illinois to meet the requirements of the Inter-Company Pooling Agreement. The State of Illinois also required a statutory deposit in the State of California. On February 9, 2006, a statutory deposit was established with the California Department of Insurance in the amount of \$1,666,792.

MANAGEMENT AND CONTROL

The following abridged organizational chart, which is limited to the Company's parent along with its subsidiary insurance companies, depicts the Company's relationship within the holding company system:



(*) all ownership is 100% unless otherwise noted

Management of the Company is vested in a three-member board of directors elected annually. A listing of the members of the board and principal officers serving on December 31, 2005 follows:

Directors

| <u>Name and Residence</u> | <u>Principal Business Affiliation</u> |
|--|--|
| Robert M. Bordeman Hinsdale, Illinois | Chief Executive Officer, Secretary and Treasurer Safeway Insurance Company |
| William G. Parrillo Hinsdale, Illinois | Vice President Safeway Insurance Company |
| William J. Parrillo Oak Brook, Illinois | President Safeway Insurance Company |

Name and Residence

Principal Business Affiliation

Principal Officers

Name

Title

| | |
|---------------------|--|
| Robert M. Bordeman | President and Treasurer |
| William J. Parrillo | Vice President |
| William G. Parrillo | Vice President and Secretary |
| Donna Jonynas | Vice President and Chief Information Officer |
| Aaron T. Brubaker | Vice President and Director of Finance |
| Michael T. Mulligan | Vice President and General Counsel |
| Arlene Jenkins | Chief Underwriting Officer |
| Anthony Risky | Chief Investment Officer |
| Chris Kvochak | General Manager |
| Michael Clearman | Claims Manager |

Management Agreements

Cost Allocation Agreement: The parent company, Safeway Insurance Company (SIC), provides management and related services to the Company. The Company pays its share of costs and expenses on an actual cost basis without profit and makes payment to SIC. A review of the agreement disclosed that it did not provide for a settlement provision. It is recommended that the Company amend the agreement to include a settlement provision and file with the California Department of Insurance.

Tax Allocation Agreement: The Company and its affiliates are parties to a tax allocation agreement dated March 31, 2001 with its parent, SIC. Tax liabilities and recoverables realized by SIC are allocated to the respective entities as if each entity had filed on a separate return basis. The benefit or liability accrued is paid to, or paid by, the member within 30 days after the filing of the consolidated tax return.

CORPORATE RECORDS

California Insurance Code Section (CICS) 735 states that the Company must inform the board members of the receipt of the examination report. The board should be informed of the report both in the form first formally prepared by the examiners and in the form as finally settled and officially filed by the commissioner. The board must also enter that fact in the board minutes. A review of the board minutes disclosed that the prior filed Report of Examination was not presented to the Board of Directors of the Company. It is recommended that the Company comply with CICS 735.

TERRITORY AND PLAN OF OPERATION

The Company is licensed in the States of California and Illinois. The Company is authorized to transact liability and automobile insurance. The Company writes private passenger automobile insurance coverage as a direct writer covering preferred and standard risks. In 1999, the Company ceased marketing its products due to lack of response from the public, but continues to service its existing policyholders. During the examination period, the Company continued to write business through renewals and referrals. During 2005, the Company wrote \$3,465,345 of direct premium in California. The Company's parent, Safeway Insurance Company, wrote \$26,447,471 of direct premium in California during 2005.

REINSURANCE

Assumed

The Company has no reinsurance assumed.

Ceded

The following is a summary of the principal ceded reinsurance treaties inforce as of December 31, 2005:

| Reinsurer's Name | Coverage | Reinsurance Limits | Term | Company's Retention |
|-----------------------------|---|---|-----------------------------------|---|
| Safeway Insurance Company * | Private Passenger Automobile Liability | 90% QS of company's ultimate liability for all premiums, losses and expenses | 1/1/05 continuous until cancelled | 10% |
| Motor Insurance Company | Automobile Bodily Injury (BI) and Physical Damage (PD) Excess of Loss | \$300,000 per loss occurrence in excess of \$100,000 for Bodily Injury \$100,000 per loss occurrence in excess of \$50,000 for Physical Damage | 1/1/04 continuous until cancelled | \$100,000 per loss occurrence for Bodily Injury \$50,000 per loss occurrence for Physical Damage |

(*) The agreement was commuted at January 1, 2006, resulting in a loss of approximately \$200,000 in 2006.

As of December 31, 2005, reinsurance recoverables for all ceded reinsurance totaled \$970,884 and ceded reinsurance premiums payable totaled \$3,465,392.

ACCOUNTS AND RECORDS

Unclaimed Property

The California Code of Civil Procedures of Title 10 states that property remaining unclaimed by its owner for more than three years revert or escheat to the state. All businesses are required to report unclaimed property on or before October 31, of each year to the State Controller's Office (SCO). A review of the Company's outstanding check listings as of December 31, 2005 disclosed that the Company failed to comply with Title 10, CCP 1500 et seq. Upon recommendation, the Company complied with Title 10 and implemented procedures to ensure future compliance. The Company is in the process of making the proper filings with the SCO to remit the unclaimed property.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2005

Underwriting and Investment Exhibit for the Year Ended December 31, 2005

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2005

Statement of Financial Condition
as of December 31, 2005

| <u>Assets</u> | <u>Assets</u> | <u>Nonadmitted Assets</u> | <u>Net Admitted Assets</u> | <u>Notes</u> |
|--|----------------------|-------------------------------|--------------------------------|--------------|
| Bonds | \$ 9,187,209 | \$ | \$ 9,187,209 | |
| Cash and short-term investments | 757,354 | | 757,354 | |
| Investment income due and accrued | 108,209 | | 108,209 | |
| Premiums and considerations: | | | | |
| Uncollected premiums and agents' balances in course of collection | 351,967 | 25,051 | 326,916 | |
| Amounts recoverable from reinsurers | 790,884 | | 790,884 | |
| Net deferred tax asset | 16,531 | | 16,531 | |
| Electronic data processing equipment | 2,671 | 2,671 | 0 | |
| Aggregate write-ins for other than invested assets | <u>2,449</u> | <u>2,449</u> | <u>0</u> | |
| Total assets | <u>\$ 11,217,274</u> | <u>\$ 30,171</u> | <u>\$ 11,187,103</u> | |
| <u>Liabilities, Surplus and Other Funds</u> | | | | |
| Losses | | | \$ 139,976 | (1) |
| Loss adjustment expenses | | | 51,051 | (1) |
| Other expenses | | | 15,398 | |
| Taxes, licenses and fees | | | (8,389) | |
| Current federal and foreign income taxes | | | 30,040 | |
| Unearned premiums | | | 71,893 | |
| Advance premiums | | | 0 | (2) |
| Ceded reinsurance premiums payable | | | 3,465,392 | |
| Payable to parent, subsidiaries and affiliates | | | <u>67,997</u> | |
| Total liabilities | | | 3,833,358 | |
| Common capital stock | | \$ 1,080,000 | | |
| Gross paid-in and contributed surplus | | 10,920,000 | | |
| Unassigned funds (surplus) | | <u>(4,646,255)</u> | | |
| Surplus as regards policyholders | | | <u>7,353,745</u> | |
| Total liabilities, capital and surplus | | | <u>\$ 11,187,103</u> | |

Underwriting and Investment Exhibit
for the Year Ended December 31, 2005

Statement of Income

Underwriting Income

| | | |
|--------------------------------------|---------------|----------------|
| Premiums earned | | \$ 324,296 |
| Deductions: | | |
| Losses incurred | \$ 215,007 | |
| Loss expense incurred | 63,896 | |
| Other underwriting expenses incurred | <u>43,810</u> | |
| Total underwriting deductions | | <u>322,713</u> |
| Net underwriting gain | | 1,583 |

Investment Income

| | | |
|------------------------------|--------------|---------|
| Net investment income earned | \$ 413,525 | |
| Net realized capital gains | <u>3,343</u> | |
| Net investment gain | | 416,868 |

Other Income

| | | |
|--|----------------|-------------------|
| Net gain from agents' or premium balances charged off | \$ 1,079 | |
| Aggregate write-ins for miscellaneous income | <u>(1,049)</u> | |
| Total other income | | <u>30</u> |
| Net income before dividends to policyholders, after capital gains tax and before all other federal and foreign income taxes | | 418,481 |
| Federal income taxes incurred | | <u>14,177</u> |
| Net income | | <u>\$ 404,304</u> |

Capital and Surplus Account

| | | |
|---|---------------|----------------------------|
| Surplus as regards policyholders, December 31, 2004 | | \$ 7,025,937 |
| Net income | \$ 404,304 | |
| Changes in deferred income tax | (112,908) | |
| Change in nonadmitted assets | <u>36,412</u> | |
| Change in surplus as regards policyholders | | <u>327,808</u> |
| Surplus as regards policyholders, December 31, 2005 | | <u><u>\$ 7,353,745</u></u> |

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2005

| | | | |
|--|----------------------------|----------------------------|---------------------|
| Surplus as regards policyholders, December 31, 2002, per Examination | | | \$ 5,872,722 |
| | <u>Gain in Surplus</u> | <u>Loss in Surplus</u> | |
| Net income | \$ 1,564,958 | \$ | |
| Net unrealized capital losses | 618 | | |
| Change in deferred income tax | | 127,022 | |
| Changes in nonadmitted assets | <u>42,469</u> | | |
| Totals | <u>\$ 1,608,045</u> | <u>\$ 127,022</u> | |
| Net increase in surplus as regards policyholders for the examination period | | | <u>1,481,023</u> |
| Surplus as regards policyholders, December 31, 2005, per Examination | | | <u>\$ 7,353,745</u> |

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Losses and Loss Adjustment Expenses

Based upon the review conducted by a Casualty Actuary from the California Department of Insurance, the Company's reserves for losses and loss adjustment expenses were found to be reasonably stated and have been accepted for this examination.

(2) Advance Premiums

The Company did not report any advance premiums for premiums received prior to the effective date of the policies. The Company physically holds the premium payments for new policies until the effective date of the policies and then deposits and records the payments in its system. For renewing policies, payments received prior to the effective date are deposited with a corresponding credit to premiums receivable. The Company's accounting methodology for premiums received prior to the effective date of the policies is not in compliance with the National Association of Insurance Commissioners' (NAIC) Quarterly and Annual Statement Instructions. The Company was not able to determine the amount of the advance premiums and stated that the amount involved would be minimal. It is, however, recommended that the Company comply with the NAIC Quarterly and Annual Statement Instructions for reporting of advance premiums.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control: Management Agreements (Page 4): It is recommended that the Company amend the agreement to include a settlement provision and file with the California Department of Insurance.

Corporate Records (Page 5): It is recommended that the Company comply with California Insurance Code Section 735.

Comments on Financial Statement Items - Advance Premiums (Page 11): It is recommended that the Company comply with the NAIC Quarterly and Annual Statement Instructions for reporting of advance premiums.

Previous Report of Examination

None.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

_____/S/_____
Grace F. Asuncion, CFE
Senior Insurance Examiner (Supervisor)
Department of Insurance
State of California